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IN THE

Supreme Court of the United States

OCTOBER TERM, 1964

SIDNEY C. KLEINMAN and JANICE R. KLEINMAN,
Objectors-below, Petitioners,

vs.

HYMAN SAMINSKY and BETTY SIEGEL, Trustee for JOAN C. SIEGEL,
Plaintiffs-Respondents,

and

CHARLES C. ABBOTT, *et al.*,
Defendants-Respondents.

PETITIONERS' BRIEF IN REPLY TO RESPONDENTS' BRIEF IN OPPOSITION

ALEX ELSON
WILLARD J. LASSERS
AARON S. WOLFF
11 South LaSalle Street
Chicago, Illinois 60603

ARTHUR T. SUSMAN
208 South LaSalle Street
Chicago, Illinois 60604
Counsel for Petitioners

FRANK J. MILLER
325 Delaware Trust Building
Wilmington, Delaware
Of Counsel

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PETITIONERS' BRIEF IN REPLY TO RESPONDENTS' BRIEF IN OPPOSITION.

The Court Below Decided a Substantial Federal Question, Without Reliance Upon the Business Judgment Rule.

Respondents highlight the "business judgment" rule in an effort to obscure the substantial federal question in this case. The court below unquestionably decided that Keystone, as a trustee, is not an investment adviser under §2(a)(19) of the Investment Company Act of 1940 and that therefore there is no violation of §§ 10 and 15 of the Act. (App. 6a-7a). It was only after the court below concluded there was no "illegality in the structure of this investment operation • • •" that the court applied the business judgment rule (App. 9a). The business judgment

rule goes only to the fairness and reasonableness of the plan of settlement, not to the question of whether the structure of the funds was legal under the Investment Company Act. It is as to the latter question that certiorari is sought. On the face of its opinion, the court below decided the federal questions presented in the petition (Pet. 2, 9).

Respondents' attempt to confuse the issue by changing the question presented to emphasize the business judgment rule does not jive with their position that the federal question decided by the court below is not substantial (Resp. 8) and that the decision is correct (Resp. 9-11).

The court below could not have avoided the federal questions under the guise of the business judgment rule. Parties may not enter into a settlement agreement and courts may not approve or give effect to an agreement which contravenes an act of Congress. *Tennessee C. & I. R. Co.* v. *Muscoda Local 123*, 321 U.S. 590, 602-3 (1944); *Brooklyn Bank* v. *O'Neill*, 324 U.S. 697 (1945); *Boyd* v. *Grand Trunk Western R. Co.*, 338 U.S. 263 (1949); *Atlantic Co.* v. *Broughton*, 146 F. 2d 480, 482 (C.A. 5, 1944), cert. denied 324 U.S. 883 (1945); see also, *Lucas* v. *The Forty-Fourth General Assembly*, 377 U.S. 713 (1964), applying this principle on a constitutional level. Section 47(a) of the Act expressly prohibits the parties from entering into any agreement waiving rights or duties created under the Act. 15 U.S.C. § 80a-46(a). Under a comparable provision of the Securities Act of 1933, 15 U.S.C. § 77n, this Court held void an agreement to arbitrate *Wilko* v. *Swan*, 346 U.S. 427 (1953). Recognizing that it could not approve a settlement that sanctioned violation of federal law, the court below categorically decided the federal questions presented before applying the business judgment rule.

Respondents concede (Resp. 8-10, pars. 2 and 3) that the court below decided a federal question but argue that the question is not important or was decided correctly below. Respondents' argument that the federal question is not substantial is based on the false premise that natural persons may serve as trustees and be exempt as investment advisers under the Act (Resp. 8-9). Despite respondents' assertion, petitioners never stated and certainly do not agree that natural persons serving as trustees are exempt as investment advisers. Petitioners said only that individual members of a board of trustees may be exempt individually as investment advisers (Pet. 13-14). If respondents are correct that natural as well as corporate trustees are exempt as investment advisers then the implication of the decision below may be even broader than petitioners asserted.

Moreover, even if there are only ten investment companies now organized as common law trusts with corporate trustees, the question presented is of importance to hundreds of thousands of shareholders having hundreds of millions of dollars invested in investment companies. Indeed, the Keystone Funds alone have over 230,000 investors who have invested over $770,000,000.*

Respondents also assert that the Act may not be evaded today because §16 of the Act requires the Funds' directors to be elected by certificateholders (Resp. 9, p. 2). But that section does not deal with investment advisers and as petitioners stated (Pet. 10), if the decision below is correct, "the Act may be evaded today simply by creating investment companies in the form of common

* As of August 1, 1964, the Keystone Funds reported they had over 228,000 investors whose shares had a market value exceeding $902,000,000. (Report to Shareholders—Series S-4, dated August 31, 1964).

law trusts and by naming a 'trustee' to perform all of the functions of the investment adviser." That statement remains unchallenged.

Respondents concede that if Keystone is an investment adviser §15 would be violated, but argue that the defect is not "inherently unlawful" and could be cured by securing approval of the advisory contract periodically by the certificate holders (Resp. 9, 10). But the point is that the court below held (erroneously) that Keystone was not subject to the requirements of §15. It is irrelevant whether Keystone might comply with a provision of the Act that the court below held inapplicable.

Respondents restate but do not challenge petitioners' contention that if Keystone is an adviser, §10(a) of the Act has been and is being violated (Resp. 9, ¶ 3). As to the §10 violation, respondents do not even suggest that they could or would cure this defect in the Funds' structure without a directive from this Court.

In paragraph (b) on page 10, respondents attempt to come to grips, finally, with the true question presented, namely—whether Keystone is an investment adviser. Significantly, respondents have abandoned completely the scant and insupportable rationale of the court below. Respondents new tack is to ascribe to petitioners an argument they never made or would make—that only natural persons qualify for the trustee exemption.*

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* As pointed out above, petitioners never argued that "only natural persons qualify for the 'trustee' exemption" (Resp. 10). The phrase "natural persons" nowhere appears in the petition. What petitioners did say was that the meaning of trustee in the list of exemptions refers to an individual trustee who is a member of a board of trustees (Pet. 13-14).

Then, respondents say, since §2(a)(27) of the Act defines "person" as "a natural person or company", Keystone qualifies as an exempt person under §2(a)(19). Respondents thus find they must take a more extreme position to uphold the court below; for as respondents tell us (Resp. 8) there are more natural persons than corporations serving as trustees of investment trusts. While respondents would exempt all trustees under §2(a)(19), we think it is plain that Congress did not exempt as trustee any person—natural or artificial—who performs the duties and functions of an investment adviser. Respondents have left unanswered all of the other reasons advanced by petitioners as to why a trustee who performs all of the functions of an investment adviser is not exempted under §2(a)(19) as a trustee.

The poverty of respondents' position is demonstrated also by their quotation, out of context, of a parenthetical phrase at p. 441 of *A Study of Mutual Funds* (Resp. 10). The parenthetical phrase, "legally trustee under deeds of trust rather than an adviser," in context supports petitioners and reads as follows:

> "There are of course a substantial number of open-end companies and groups that do not have any external investment adviser, including MIT, Massachusetts Investors Growth Stock Fund, Century Shares Trust, and the three members of the Broad Street group. These internally managed systems are given attention here mainly because they afford a basis for comparison with companies with advisers. As may be seen by a comparison of tables VIII-7 and VIII-8 they constitute a significant fraction of the universe of open-end companies and assets, and they would be larger by another $851 million *if we had not chosen to include Keystone Custodian Funds, Inc.* (legally trustee under deeds of trust rather than

an adviser) *as an investment adviser for purposes of this study.* * * *" (emphasis added)

By treating Keystone in the group of open-end companies that do have external investment advisers, the *Study*, prepared by economists and professors at the Wharton School of Finance and Commerce for the Securities and Exchange Commission, chose to "include Keystone * * * as an investment adviser * * *". So do petitioners.

The parenthetical phrase states only what is obvious, namely that Keystone is labelled a trustee under a deed of trust. The *Study* was not there concerned with the question involved here—whether Keystone which is designated a trustee in the deed of trust is also exempt from all of the provisions of the Act with respect to advisers.*

Also without merit is respondents' argument that the Securities and Exchange Commission has not yet complained that Keystone's structure is unlawful (Resp. 11). Private enforcement of securities legislation provides a necessary supplement to Commission action. *J. I. Case Company* v. *Borak*, 377 U.S. 426 (1964). And the wisdom of that rule is evident here, since the chancery court held that the underwriting contract between Keystone of

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* Note also that the *Study* at p. 46, cited by respondents (Resp. 8), asserted that Keystone shareholders did not have power to vote annually on underwriting contracts. The *Study*, conducted by laymen, was not concerned with that assertion as a question of law but as a matter of fact and can hardly be criticised for not predicting that failure to obtain shareholder approval rendered such agreements void under the Act. See *Saminsky* v. *Abbott*, discussed at Petition 6 and in the following paragraph.

Boston and Keystone, a contract which had been in existence for over twenty years with the knowledge of the Commission, was void under the Act. See *Saminsky* v. *Abbott*, 185 A. 2d 765 (Del. Ch. 1961) discussed at Pet. 6.

Finally, respondents' argument based on ratification is totally irrelevant (Resp. 4, 6, 8). It relates to the application of the business judgment rule, a question which is not before this Court. The question is whether the structure of the Funds is in violation of the Act. The latter question was never before the certificateholders for ratification (DA 80—2 to 5; 106); nor was it before them in the notice of settlement (DA 33-39). In any event, as shown above, the illegal structure of the Funds may not be ratified or approved by certificateholders and a plan of settlement which sanctions continuing violations of the Act is void against public policy and cannot be approved by any court.*

Respondents also make much of the fact that of more than 230,000 certificateholders, only petitioners objected to the settlement (Resp. 6), a fact that we pointed out in the petition (Pet. 7). If there is any magic in numbers, we think that if two certificateholders can enter into a settlement agreement on behalf of 230,000 certificate

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* Respondents' assertion (Resp. 4) that more than 90% of the certificateholders of each fund, including petitioners, voted for ratification, is erroneous. For example, by far the largest of the 10 Keystone funds is "S 4". Only 58% of the outstanding shares of that fund were voted in favor of ratifying management fees (DA 91) and only one of petitioners signed a proxy (DA 106). Moreover, respondents' suggestion that petitioners lack standing to object because one of them signed a proxy was rejected expressly by the chancery court (PA 65) and sub-silencio by the Delaware Supreme Court, although respondents argued it there at length.

holders, then the same number can upset such a settlement—especially so where the settlement sanctions continuing violations of the Investment Company Act of 1940 and deprives hundreds of thousands of small investors of the protection congress intended them to have.

Conclusion.

For the reasons set out above and in the Petition, the petitioners respectfully request that this Court issue a Writ of Certiorari to the Supreme Court of Delaware and reverse the judgment of that court.

Respectfully submitted,

ALEX ELSON
WILLARD J. LASSERS
AARON S. WOLFF
11 South La Salle Street
Chicago, Illinois 60603

ARTHUR T. SUSMAN
208 South La Salle Street
Chicago, Illinois 60604
Counsel for Petitioners.

FRANK J. MILLER
325 Delaware Trust Building
Wilmington, Delaware
Of Counsel

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